

An exempt organization's income from a mineral interest is not a royalty excluded from the computation of unrelated business taxable income by section 512(b)(2) of the Code where the organization is liable for the operating expenses associated with its interest.

Advice has been requested whether certain income received from a mineral lease by an organization exempt from Federal income tax under section 501(a) of the Internal Revenue Code of 1954, but subject to tax under section 511 on its unrelated business taxable income, is excluded in computing unrelated business taxable income by section 512(b)(2).

The organization owned a working interest in oil and gas producing property. Under the terms of an agreement with an independent operator, it was relieved of liability for the development costs associated with the interest, but remained liable for the expenses of operating the property.

Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income all income from royalties.

Section 1.512(b)-1(b) of the Income Tax Regulations provides that where an organization owns a working interest in a mineral property and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded in computing unrelated business taxable income.

The regulations are silent as to the effect of liability for operating costs. However, a royalty interest is a right to a mineral in place that entitles its owner to a specified fraction of the total production from the property, free of expense of both development and operation. Section 1.512(b)-1(b) of the regulations does not imply that the income from an interest burdened with operating costs may be excluded from the computation of unrelated business taxable income, since section 512(b)(2) of the Code excludes from such computation only the income from royalties. To be a royalty interest, the right to payment must be free of both development and operating costs. The regulations refer to relief from development costs only by way of illustration.

It is held that the income from the mineral interest is not a royalty and therefore is not excluded from the computation of unrelated business taxable income by section 512(b)(2) of the Code because the owner of the interest is not relieved of the operating costs associated with his interest.